Special Report - Gold as an Investment

Context

Due to the on-going war against the COVID-19, local and foreign equity markets have fallen significantly from their peaks and remain highly volatile. Moreover, with the central banks around the world cutting key interest rates to nearly zero, yields have considerably fallen. Fixed income investors are now exposed to the risk of earning negative real interest rates.

The purpose of this paper is to analyse whether Gold, as an investment, can be used by Pension Funds as a diversifier in the Strategic Asset Allocation.

Overview

Throughout the world, gold has been rather well respected for its store value and rich history, which has been intertwined into cultures for thousands of years. Many people see gold as a way to pass on and preserve their wealth from one generation to the next.

In recent times, gold has proven itself to be highly effective investment vehicle for diversification and risk management because of its independence from other asset classes.

Unlike the recent downfall of the Equity and Fixed Income Markets, the latest performance of gold has been commendable.

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The below table illustrates the recent returns of Gold, Foreign Equities Index (MSCI ACWI), Foreign Bond Index (Bloomberg Barclays Global Aggregate) and the SEMTRI in MUR terms.

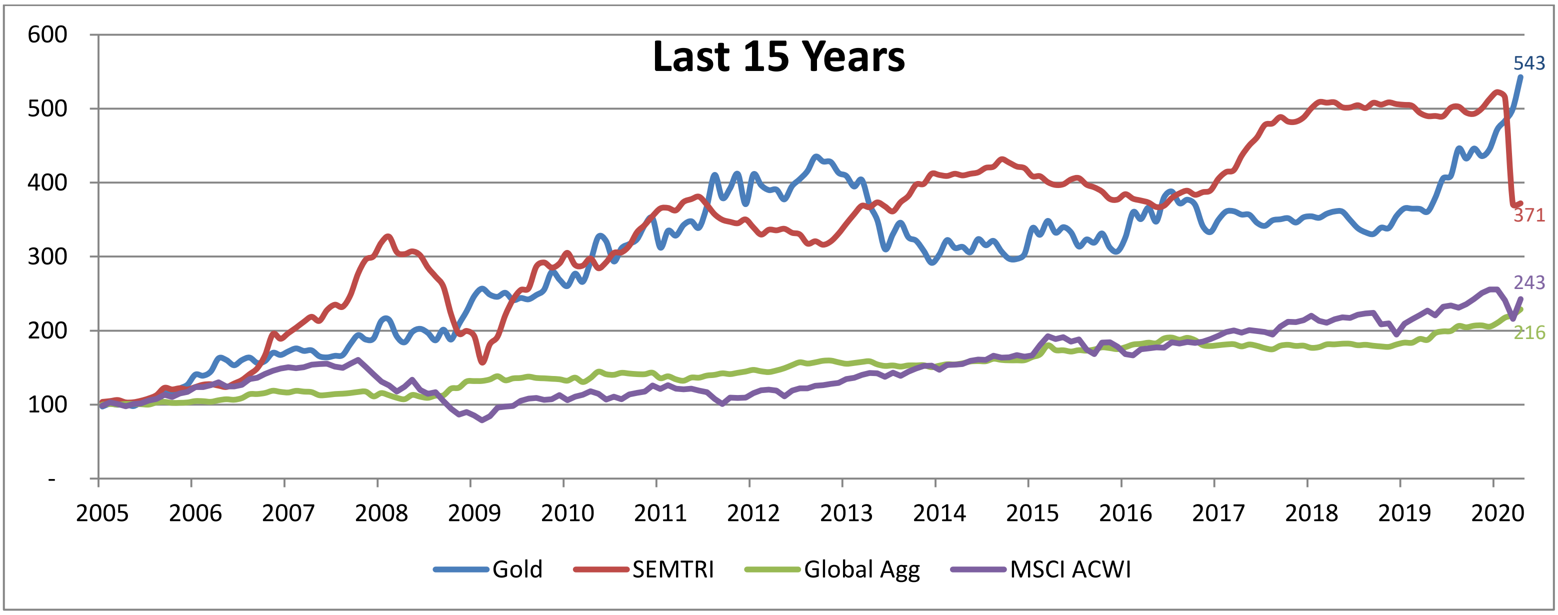
Performance in Mauritian Rupees (as at 30/04/20)	Year to Date	Last 12 Months	Last 3 Years (Annualised)
Gold	22.4%	50.6%	14.8%
SEMTRI	-27.5%	-24.1%	-5.2%
MSCI ACWI	-4.1%	8.6%	9.0%
Bloomberg Barclays Global Aggregate Bond Index	11.9%	21.8%	8.3%

Note:

1. The above performance takes into consideration the appreciation of the US Dollar against the Mauritian Rupee. The USD has appreciated by 10.1% against the Mauritian Rupee on a year to date basis, by 14.3% over the last 12 months and by 4.3% annualised over the last 3 years.

2. Bloomberg Barclays Global Aggregate Bond Index is referred to as 'Global Agg' in the document.

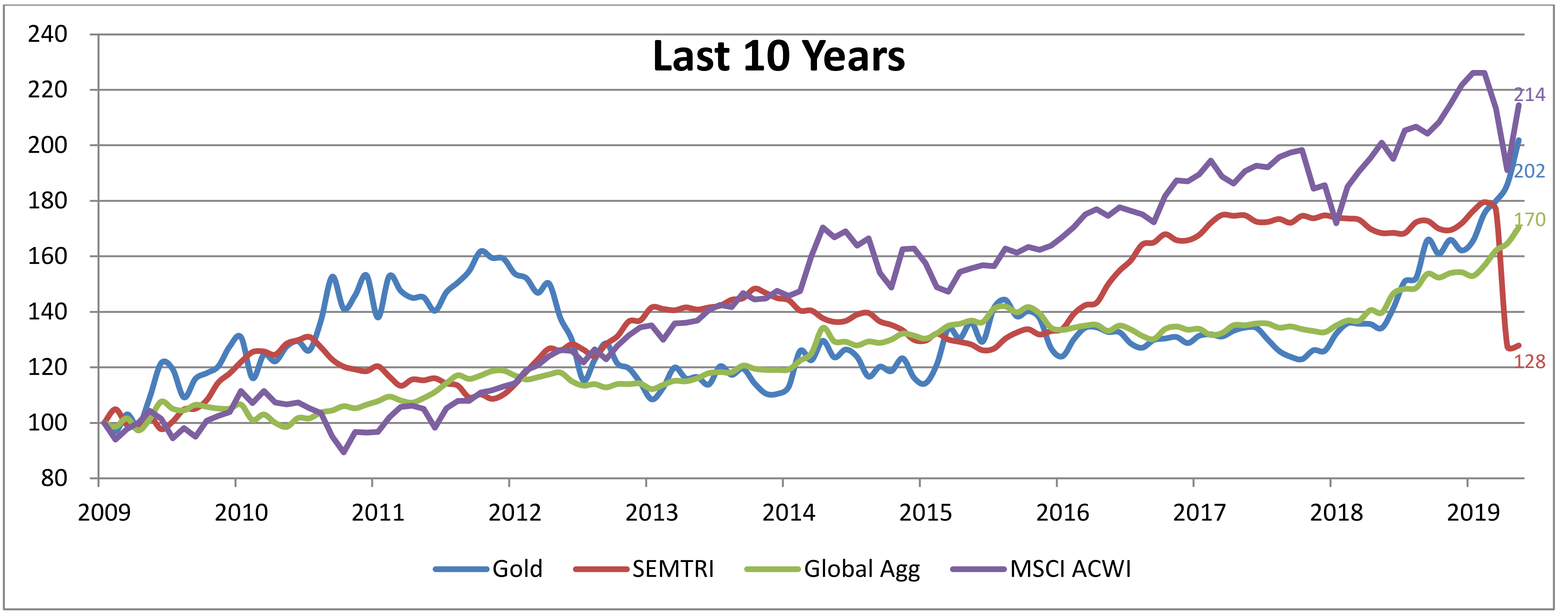
On a longer time period, the below charts show the historical trend of the different asset classes over the last 15 years and over the last 10 years as at 30 April 2020 in Mauritian Rupees.



The above diagram shows that if an individual had invested MUR 100 in 2005 in Gold Futures, the position as at 30 April 2020 would be worth

MUR 543. The same applies for the other asset classes.

Over the last 10 years, the time series is shown on below:



From the historical data, we note the following:

- Over the last 15 years, taking into consideration the financial crisis of 2008 and the recent market downturn, Gold has been the highest performer.
- Over the last 10 years, taking into consideration the recent boom in Foreign Equities, MSCI ACWI is the highest performer. Gold comes in second.
- Over the long term, the volatility between asset classes is very different.
- The SEMTRI (red line) shows the same trend as the MSCI ACWI (purple line). This shows that investing only in local and foreign equities may not be very effective in terms of diversification

To further understand the volatility between the asset classes, in the next section, we look at the correlation between the asset classes.

Correlation

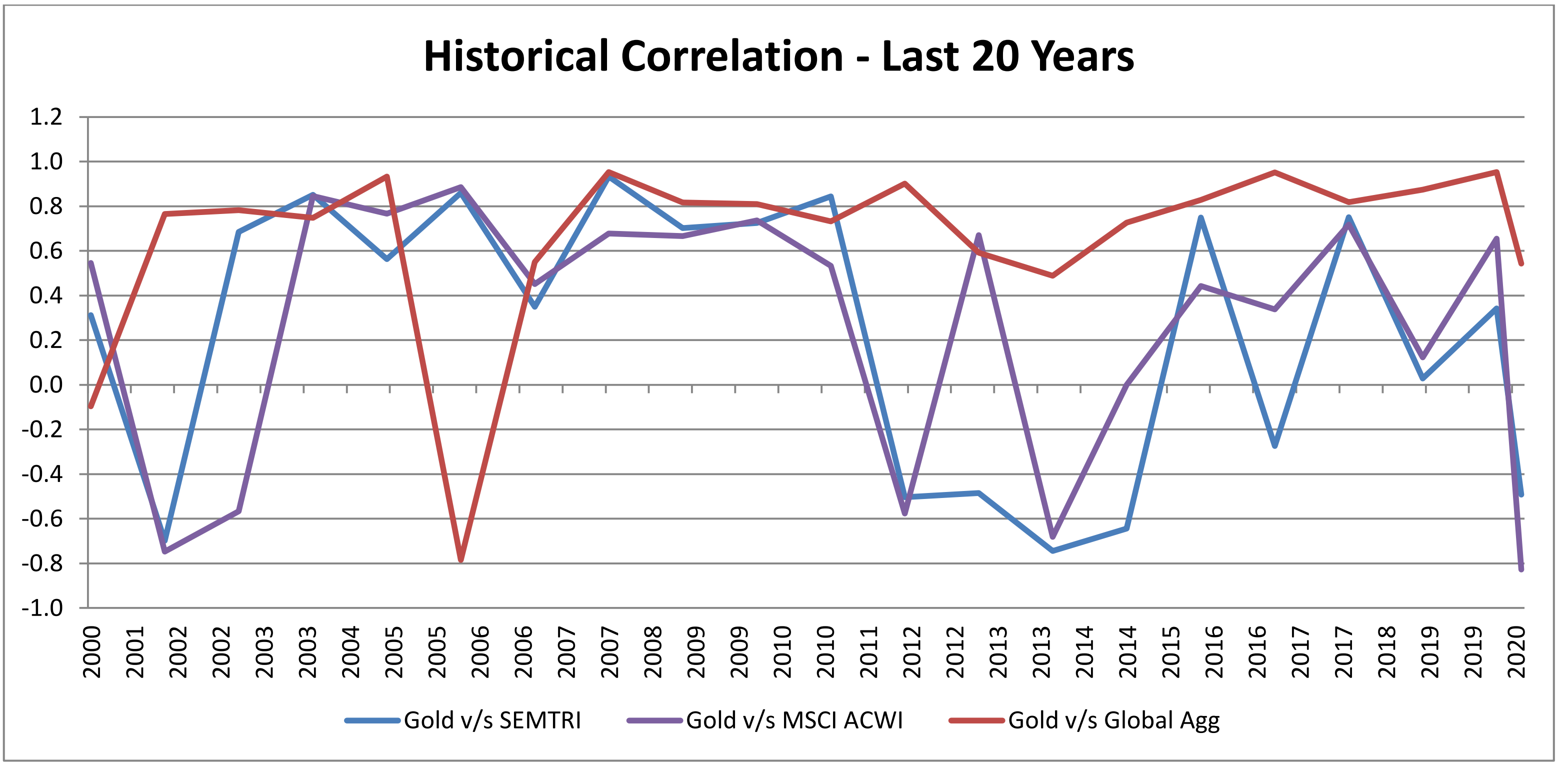
The traditional view is that three asset classes (stocks, bonds and cash) are sufficient to achieve diversification. However, in today's context, this may not be the case. This is illustrated in the correlation table below:

Correlation	Last 3 Years	Last 12 Months
Gold v/s SEMTRI	-31.43%	-41.60%
Gold v/s Global Agg	94.38%	93.81%
Gold v/s MSCI ACWI	27.40%	-12.71%

The SEMTRI shows a **<u>negative</u>** correlation with gold over the recent period. The MSCI ACWI shows very low correlation with gold over the last 3 years and interestingly negative correlation over the last 12 months. **This further strengthens the argument that Gold can be used as an equity portfolio diversifier.**

The Bloomberg Barclays Global Aggregate Bond Index has however demonstrated strong positive correlation in recent times.

To better illustrate the correlation argument, the below chart analyses the historical correlation between the different asset classes.



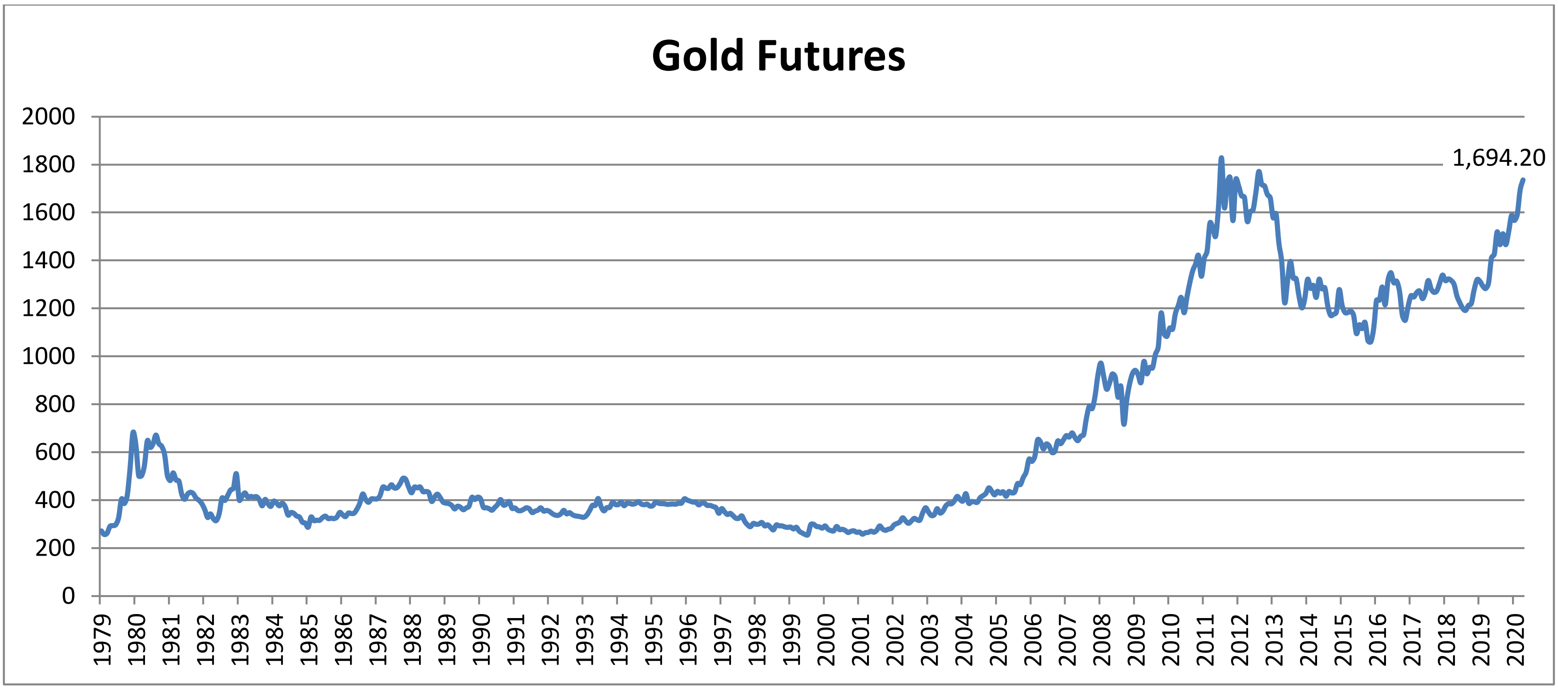
The equity markets correlations (i.e. the SEMTRI and the MSCI ACWI) generally follow a similar trend. **<u>Therefore, an investor who invests solely in local and foreign equity markets cannot achieve perfect diversification (especially in equity market downturns).</u>**

The Bloomberg Barclays Global Aggregate Bond Index shows positive correlation since 2007.

History of Gold Price

Over the past 40 years, the historical return on Gold Futures is 4.5% on an annual basis. However, in the recent periods, gold has witnessed flash rallies as well as downturns.

On the next page, the chart analyses the historical price of Gold Futures (in USD terms) since 1979.



Aon Comments:

- From 1981 to 2004, the price of Gold Futures was almost flat with very low volatility (on a year on year basis).
- For the next 10 years ending December 2014, the commodity has returned 10.5% annually.
- This is largely explained by the Financial Crisis in 2008 and the negative/low correlation of Gold with other asset classes.
- Over the next 6 years, as at time of writing, the commodity has witnessed high levels of volatility.
- Since July 2018, the price of Gold Futures has been following an upward trend.
- Gold Futures are currently trading at USD 1694.20 (as at time of writing – 30 April 2020). This is slightly less than the peak of August 2011 where it was hovering around USD 1828.5.

The above analysis concludes that while entry time is crucial when in investing in Gold, investors should also be willing to hold the asset class on a long term basis for the sake of diversification.

Moreover, the chart shows that when the prices of Gold Futures have been on an upward trend for a considerable amount of time, the prices have always surpassed the all-time high. **Given current conditions, we are of the view that this situation could repeat.**

Outlook on Gold Prices

The following section includes independent research provided by well-known third parties such as Goldman Sachs and Morgan Stanley.

Goldman Sachs [1]

Goldman Sachs has been bullish on gold over the long haul due to potential of a "shock to the global economy" following the COVID-19 outbreak. Nevertheless, it trimmed the forecast for the next half year as a result of potentially less central-bank buying. Analysts at the asset management firm left their 12 months outlook at USD 1,800.

Morgan Stanley [2]

Morgan Stanley has shared similar views. They argue that while Gold may seem vulnerable after its rapid +30% rise since last fall (over +45% since the late-2015 trough), with many indicators suggesting increased investor enthusiasm, gold remains attractive, and they expect gold to reach USD 2000 by 2021. The major reason for the bullish outlook is due to the increasing likelihood of wider budget deficits and looser monetary policy globally.

Investment Methods

Investment in gold can be made in numerous ways, depending on the investment objective being sought.

1. **Bars and Coins**

Purchasing gold coins and bars, either to store personally, or to be held securely on one's behalf by a bank or other financial intermediary.

Examples:

- Coins
- Collector coins
- Gold bullion bars

2. **Exchange Traded Funds (ETFs)**

Financial products physically backed with allocated gold bullion, listed on a stock exchange, and bought and sold in the form of shares. Most common examples include iShares Gold Trust, SPDR Gold Shares ETF, etc.

Note that there is also a gold ETF listed on the Stock Exchange of Mauritius.

[1] *Goldman Sachs: https://www.kitco.com/news/2020-03-17/Goldman-sticks-to-1-800-gold-price-in-12-months.html*

[2] *Morgan Stanley: https://www.morganstanley.com/im/en-gb/intermediary-investor/insights/macro-insights/gold-bull-market-to-continue.html*

3. Gold Accounts

Gold bullion stored and managed by a bullion dealer or depository.

Examples:

- Allocated gold accounts
- Unallocated gold accounts
- Gold accumulation plans

4. Other Gold - linked products

Indirect investments in gold, via financial instruments, without direct ownership of the metal. Examples include:

- Gold mining stocks
- Futures and options

Aon View:

The Gold Market is considered very liquid. Nonetheless, we do not recommend pension clients to invest in Physical Gold or hold Gold Accounts directly.

This will normally involve storage and insurance cost and can become administratively difficult to handle. There are many other risk factors involved.

For Pension Funds, the most convenient way to gain exposure to Gold is through an Exchange Traded Fund (ETF), due to the higher liquidity, lower expenses and reduced administrative tasks.

Pros & Cons

Throughout the years, there have been many advantages and disadvantages in investing in the world's most renowned commodity.

The major **advantages** for an investor are as follows:

- Gold acts as a diversifier due to negative/low correlation with equities and other traditional asset classes.
- Gold acts as a hedge against inflation/deflation. This is very likely given Covid-19 crisis. The commodity is more likely to preserve its value.
- Gold retains its value not only in times of financial uncertainty, but in times of geopolitical uncertainty. It is often called the 'crisis commodity'.
- Demand and Supply Economics: As a general rule, reduction in

the supply of gold increases gold prices. Note: It can take from five to 10 years to bring a new mine into production.

- Good historical return on a long term basis. Moreover, investments in Gold are very liquid through ETFs.
- The outlook on Gold is positive in current context.

The major **disadvantages** for an investor are as follows:

- In contrast to traditional sources of Investment, Gold does not provide a regular income.
- In many cases, storage/insurance costs are involved. However, this is not the case when using ETFs.
- While Gold can be volatile on a short term period, the historical gold prices have demonstrated that investors must be willing to hold the asset class on a long term basis to benefit of slow appreciation of the commodity.

All things considered, currently, our view is that the advantages outweigh disadvantages, especially during a market crisis.

Conclusion

Gold, as an investment diversifier, is popular among investors because it can be used as a **hedge against currency devaluation, inflation, or deflation, and due to its ability to provide a "safe haven" during times of economic uncertainty**. This has been demonstrated in the correlation of Gold against other asset classes.

In an overall portfolio context, Pension Funds, which already have exposure to equities and bonds, may consider investing in Gold to further diversify the portfolio.

Nevertheless, Aon would recommend clients to cap the investments in Gold ETFs at around 5% of the overall portfolio.
